

14 November 2017
Ms Karen Chester
Deputy Chair
Productivity Commission
GPO Box 1428
CANBERRA ACT 2601

Dear Ms Chester

Submission to the Commission's Inquiry into Horizontal Fiscal Equalisation

We refer to the above inquiry and provide as a submission a research report published by the Institute of Public Affairs. The report refers to the following terms of reference:

- Whether the present adoption by the CGC of a HFE formula to equalise states' revenue raising and service delivery capacities is in the best interests of national productivity; or whether there may be preferable alternatives. On this matter the Productivity Commission should enquire as to whether this aspect of the CGC formula or any other aspect of it may restrict the appropriate movement of capital and labour across state borders to more productive regions during times of high labour demand.
- Whether the present HFE formula may have the effect of producing a disincentive for a state to develop a potential industry or raise a royalty rate for an existing industry at an appropriate time.

Our report argues that horizontal fiscal equalisation is fundamentally flawed for conceptual reasons and is associated with a number of practical problems. There is no justifiable rationale for jurisdictional equalisation, while in practice equalisation is riddled with uncertainty and complexity.

Importantly, equalisation reduces the incentive for mobile factors of production (such as labour and capital) to move to higher productivity locations, imposing efficiency costs on the national economy. Labour market mobility is an important, but overlooked, source of productivity gain, and there is no reason why the movement of labour and capital should be discouraged merely because it would result in economic activity and investment in certain jurisdictions.

Equalisation also incentivises state governments to avoid undertaking important microeconomic reform, as such reforms would risk a change in the applicable equalisation formula. This sees the benefits of such reform effectively distributed to the other states and a reduction in what a state would be entitled to if it did not undertake reform.

Above all else, horizontal fiscal equalisation fails to adequately address (and actively entrenches) the core issue afflicting federal-state relations in Australia – namely the high degree of vertical fiscal imbalance in favour of the Commonwealth.

Our report recommends that horizontal fiscal equalisation should be abandoned as a policy objective. In its place, the principles of decentralisation should be adopted to unlock the benefits of competitive federalism. This would mean that while the Commonwealth would retain the responsibility for collecting GST revenue, the states would be given the power to set the GST rate that applies in their respective jurisdictions. Each state should be entitled to claim the proportion of the total national GST revenue that is attributable to that particular state.

In the absence of fundamental reform, GST revenue should be distributed should be based on state of origin principles (what is raised in a state is retained by that state) or on an equal per capita basis. While these methods would not resolve the fundamental issue of centralised taxation that is at the core of vertical fiscal imbalance, they are a significant improvement on any equalisation methodology.

The IPA trusts that our contribution will be of assistance to the Productivity Commission. I would be pleased to answer any further questions. Please do not hesitate to contact me in writing to 2/410 Collins Street, Melbourne VIC 3000; by telephone; or by email

Regards,

Morgan Begg

Research Fellow
Institute of Public Affairs